

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of)

Implementation of Sections of the)
Cable Television Consumer)
Protection and Competition)
Act of 1992)

Rate Regulation)

MM Docket No. 92-266

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TO: The Commission

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**REPLY COMMENTS OF THE
NATIONAL ASSOCIATION OF BROADCASTERS**

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ENCLOSURE

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Summary

While many of the cable interests filing comments declined to suggest or endorse any approach to regulating rates, and others suggested plans that would be burdensome to the Commission and franchise authorities, or would not lead to changes in the prices which consumers pay for cable service, the Commission does not have the luxury of waiting until a perfect plan could be developed, if such a plan could exist. Instead, the Commission must now devise a plan for regulating the rates which cable systems charge consumers.

That plan, contrary to suggestions in some cable comments, must result in a real reduction in cable prices. Congress did not act solely to reign in a few "outliers" who charge prices out of line with the rest of the cable industry. To the contrary, Congress concluded that the "overwhelming majority" of cable systems are reaping monopoly rents and directed the Commission to move cable rates to competitive levels. NAB's rate proposal, developed by Strategic Policy Research, would achieve Congress' goal.

The Commission's rate-setting authority is not constrained, contrary to some cable arguments, by constitutional limits. The Constitution only bars rates which are set so low as to completely destroy the value of the regulated property. Since basic service tier channels will be only a part of the services cable systems offer, and other services are regulated either less stringently or not at all, there can be no argument that the basic service rate, no matter how low, would eliminate any possibility of remunerative use of the cable system. Further, the Supreme Court has made clear

that if owners of regulated companies take on indebtedness in amounts which exceed their properties' reasonable value, a constitutional rate can be set based on the fair value of the property, even if it is based on a valuation that is less than a cable operator paid for a system in the expectation of future monopoly prices.

The cable comments almost universally insist that any retransmission consent fees which cable systems agree to pay broadcasters be added to whatever benchmark rate the Commission establishes. These requests ignore the fact that the value of retransmitted signals is already incorporated in the rates which cable systems have charged consumers, although cable systems have not been required up to now to compensate broadcasters for that value. If basic service rates were established based on existing or historical cable rates, and retransmission consent fees were added to those rates, cable systems would obtain a double recovery at the expense of consumers. Either the value derived from retransmitted broadcast signals must be unbundled from a rate-based benchmark or the rate benchmark should be established on the basis of cable system costs, in which case retransmission consent costs would be accorded the same treatment as any other costs of obtaining basic tier program services.

Many cable operators indicate that the Cable Act mandates the creation of a "broadcast basic" tier limited to broadcast signals and PEG channels. The Act *allows* for such tiers, but certainly does not *require* them. The Commission should not formulate rate benchmarks which would induce cable systems to move services off of basic tiers. Had Congress desired to compel the creation of such limited tiers, it

would not have indicated that retiering could be deemed an act of evasion of the Cable Act's rate regulation requirements.

Turning to the alternative approaches for regulating basic cable service, it is clear that no one supports adoption of traditional telephone-type cost of service regulation. The Commission instead, as it proposed, should adopt a benchmark approach. The benchmark might be established in two ways — based on rates or costs. NAB believes that a cost-based benchmark is the superior approach.

Adopting a rate-based benchmark would require the Commission to make a series of difficult decisions. If it uses the rates charged by competitive systems, it must first determine which systems have rates that reflect true competitive conditions. If it uses historical cable rates, it would have to select systems whose rates were indicative of what competitive rates would have been, and then would have to decide on what basis those past rates could be adjusted to reflect changes in costs and other conditions. Average present rates, although simple, could not be used to set a benchmark unless the Commission could find that those rates are an adequate proxy for the rates that would obtain under competitive conditions, a conclusion which seems at odds with the facts found by Congress.

Whatever rate would be selected to establish a benchmark, the Commission would have to formulate a method to unbundle the benchmark rates to reflect differences in the programs and number of channels provided as part of basic service and in equipment included in past or present basic tier rates. It would also be required to develop a way to adjust the benchmark rate in the future.

Using a cost-based benchmark as suggested by NAB would eliminate many of these difficulties. Rather than speculating about the effect of differing product mixes on past or present rates and attempting to determine the level of monopoly rents incorporated into any existing rates, the Commission would only have to arrive at a replacement cost matrix for the capital equipment needed to provide cable service. This could be accomplished using readily available industry data or expert consultants in cable construction. A cost-based benchmark would be simple for local authorities to apply, and variations in cable system technology and program services could be readily accommodated in the rate calculation.

The NAB cost-based benchmark proposal also would not create disincentives for investment. By permitting cable operators to recognize the costs of basic service programming, the NAB approach would not establish incentives to "game" the system that would be inherent in a rate-based cap, and would not induce cable operators to move popular cable program services off of the basic service tier. The Besen study submitted by TCI suggest seven principles for effective basic tier rate regulation. The NAB proposal would be consistent with all seven principles.

Finally, a number of cable operators argue that, for purposes of § 623(d) which requires uniform rates across a cable system, the term "cable system" should be read to include only a single franchise area, even if a cable operator combines a number of such systems into one "technically integrated" system. That suggested definition, however, is inconsistent with the definition propounded by many of the same cable operators in the must carry proceeding, where they argued that a "techni-

cally integrated" group of systems operating across ADI lines should be regarded as one cable system. NAB opposed that reading of the Act in the must carry proceeding; the term "cable system" should generally refer to a specific franchise area. The Commission should not allow cable systems to have it both ways.

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**REPLY COMMENTS OF THE
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The National Association of Broadcasters ("NAB")^{1/} submits this reply to the comments filed in response to the Commission's *Notice of Proposed Rule Making* ("*Notice*").

Introduction

The plethora of comments received by the Commission are useful in illuminating the complexity of establishing a workable rate regulation system for the cable industry. For the most part, however, the comments submitted by cable interests do not propose practical alternatives for the Commission's consideration. The Nation's two largest cable operators indeed decline to endorse any method of regulating basic tier rates. Comments of TCI at 17; Comments of Time Warner at 23. Many

^{1/} NAB is a nonprofit, incorporated association of radio and television stations and networks which serves and represents the American broadcast industry.

suggestions for rate regulation plans proposed to the Commission would require complex and difficult calculations, likely to be beyond the capabilities of the Commission or of local authorities to implement. Others suggest ways to calculate rates that would essentially leave cable systems free to continue charging the rates they now do, or even to add to the cost of cable service. Further, many sets of comments rely on ill-defined constitutional arguments which have little bearing on any proposal before the Commission in this proceeding.

Many of the comments filed by the cable industry seem to misunderstand the reasons why Congress reinstituted rate regulation. Based on NCTA's comments, the Commission could conclude that Congress was only interested in ensuring access to a limited basic tier for poorer Americans. NCTA (Comments at 3-4) also rehearses the tired argument that Congress in 1984 intended to allow the substantial increase in cable prices that occurred following deregulation, and that the 1992 Act was only a reaction to a few cable operators who abused their privileges. To the contrary, Congress deregulated cable rates in 1984 because it believed, based on assurances from the cable industry, that widespread, effective competition to most cable systems was imminent.^{2/} Congress certainly would never have knowingly adopted a policy of

^{2/} See S. REP. NO. 67, 98th Cong., 1st Sess. 11 (1983)("With the development of competitive programming services . . . the need to regulate cable as was originally proposed by the Commission in 1972 is seriously in doubt"); *Options for Cable Legislation: Hearings on H.R. 4103 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 30 (1983)(Statement of Thomas E. Wheeler, President, National Cable Television Association); see also H. REP. NO. 628, 102d Cong., 2d Sess. 30 (1992)[hereinafter *House Report*].

encouraging rate increases by an unregulated monopoly. Moreover, it was not just the excesses of a few operators that led to the 1992 Cable Act. The Senate Commerce Committee stated:

"[T]he cable industry itself recognizes that it holds monopoly power. This demonstrates the need to encourage competition and to reimpose regulation of the cable industry, particularly rate regulation, *to the overwhelming majority of cable systems* in this country which are monopolies and not subject to effective competition."^{3/}

The Senate quoted from a brief filed by TCI in which it stated that, because franchise holders have monopolies, "the prospective cable operator would be able to generate a cash flow that would result in a supernormal return on investment"^{4/} Moreover, a Department of Justice staff study in 1991 determined that at least half of the post-deregulation increases in cable rates could be attributed to monopoly rents.^{5/} Congress, therefore, concluded that the excessive cable rate increases following deregulation were the product of cable systems' monopoly power, and were not merely the benign "catch-up" increases or increases reflecting additional services that the cable comments depict. That the cable industry wants the Commission to disregard Congress' intent is best demonstrated in comments which, in discussing a possible benchmark based on prices in competitive systems, argue that the prices

^{3/} S. REP. NO. 92, 102d Cong., 1st Sess. 9 (1991)[hereinafter *Senate Report*] (emphasis added).

^{4/} *Senate Report* at 9 (quoting Reply Brief of Telecommunications, Inc., *Telecommunications, Inc. v. Commissioner*, 95 T.C. 36 (1990), at 149-50).

^{5/} Rubinovitz, *Market Power and Price Increases of Basic Cable Service Since Deregulation*, Dept. of Justice Economic Analysis Group (EAG 91-8), Aug. 6, 1991.

charged by the few cable systems which actually face competition should be disregarded by the Commission since competition has made those prices "artificially low."^{6/}

The task for the Commission, therefore, is not to ratify existing rates or to base a rate benchmark on rates incorporating capitalized monopoly rents, but instead to develop a rate regulation regime under which cable service will be provided at rates approximating those which would obtain in a competitive environment, rates which the Commission should without question believe are well below the prices consumers now pay. Rather than seeking to avoid the meaningful controls which Congress envisioned, as we will discuss, the NAB proposal for basic service tier rate regulation would achieve that objective without creating undesirable incentives to "game" the system or imposing unreasonable regulatory costs.

The Claimed Constitutional Restrictions on the Commission's Rate-Setting Authority

Many cable comments (*see, e.g.*, Comments of NCTA at 34; Comments of Continental at 22) argue that the Constitution tightly restrains the Commission's ability to set rates. At bottom, these comments argue that the Commission must accept without question whatever costs were incurred by cable operators to acquire their systems and provide for recovery of those amounts. The Constitution, however, imposes no such strictures.

^{6/} Comments of NCTA at 17; *see* Comments of Continental at 22; Kelley, *The Economics of Cable Television Regulation* 24 (Attached to Comments of Time Warner)[hereinafter *Time Warner-Kelley Study*].

To be sure, confiscatory rates may be deemed a violation of the Takings Clause of the Fifth Amendment. A confiscatory rate in this context, however, is one which is "so unjust as to destroy the value of property for all the purposes for which it was acquired." *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 597 (1896). Thus, the fact that a rate might not result in a profit for a particular cable operator will not raise a constitutional question. Further, although a legally required rate may determine all, or virtually all, of the revenues which a traditional utility's owner can derive from its property, the rates established by the Commission in this proceeding will not limit the total revenues which cable operators may earn from their systems. Services offered on a pay-per-view or pay-per-channel basis are entirely unregulated under the Act, and cable systems may charge customers whatever amount marketplace conditions permit. Also, if cable operators develop other uses for part of their systems such as PCS or other data or telephone services, those prices would also be unregulated under the Cable Act. Even with respect to the regulated tiers of cable service, the Commission may allow greater flexibility for cable operators in pricing upper service tiers and may provide that cable operators receive all or part of the revenues which they obtain from advertising on cable program services without affecting the rates charged for such tiers.²¹ Arguments that the rates estab-

²¹ While the Act permits the Commission, in establishing basic tier rate regulations, to take into account advertising or other compensation received in connection with services provided on the basic tier (§ 623(b)(2)(C)(iv)), under NAB's rate proposal, advertising revenues from services provided on the basic service tier would not reduce the legally permitted rate for basic service. See Comments of NAB at 20.

lished by the Commission for basic service are confiscatory, therefore, must be viewed skeptically since, whatever rate is established, it is not likely to destroy all value of the cable system.

Further, the Supreme Court has pointed out that questions of what is a fair rate of return or whether a particular rate is unjust have constitutional overtones only "at the margins." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989). "[A]ll of the subsidiary aspects of valuation for ratemaking purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree." *Id.*; see *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). In the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Court elaborated as follows:

"No constitutional objection arises from the imposition of maximum prices merely because 'high cost operators may be more seriously affected . . . than others,' or because the value of regulated property is reduced as a consequence of regulation. Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness."^{8/}

The Commission is also entitled to use generalized cost data to establish cable rates. "[L]egislatures and administrative agencies may calculate rates for a regulated class without first evaluating the separate financial position of each member of the class; it has been thought sufficient if the agency has before it representative evidence" *Id.* at 769.

^{8/} 390 U.S. at 769 (citations omitted).

NAB proposed that the capital component of a basic service tier rate benchmark be derived from a formula based on the replacement cost of the capital equipment used by a cable system, rather than the cost of acquisition. Were original costs that were paid with the expectation of continued monopoly prices to be factored into a rate equation, the resulting rate would continue to include monopoly rents and thus be contrary to Congress' objective of establishing rates at a level which would be charged in a truly competitive environment.^{9/}

The Commission will no doubt receive reply comments arguing that using replacement costs to establish a benchmark would result in illegal and confiscatory rates. Putting aside the question of whether even a confiscatory rate for basic service alone would present any constitutional objections, the assumption that constitutionally permissible rates must take into account actual costs, no matter how imprudently incurred, is simply wrong. In *Smyth v. Ames*, 169 U.S. 466 (1898), the case primarily relied on by NCTA,^{10/} the Court rejected any such contention:

"If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is largely fictitious, it may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization; and the apparent value of the property and franchises used by the corporation, as represented by its stocks, bonds, and

^{9/} See Haring, Rohlf & Shooshan, *Efficient Regulation of Basic-Tier Cable Rates* 8 (Appendix A to the Comments of NAB)[hereinafter *NAB-SPR Study*].

^{10/} Comments of NCTA at 34.

obligations, is not alone to be considered when determining the rates that may reasonably be charged."^{11/}

Thus, if the Commission determines that the replacement cost of cable systems is an appropriate measure of the costs which a prudent cable operator would incur to provide cable service, that cost may constitutionally be used as the basis for setting a rate for cable service, regardless of whether any particular cable operator paid a greater amount to acquire its system in anticipation of continuing monopoly prices.

Retransmission Consent Costs Should Not be Added to Rate-Based Basic Tier Benchmark Prices

Although many cable operators declined to endorse a specific benchmark, the cable comments were almost universal in arguing that any costs which cable systems now incur for retransmission consent under § 325(b) of the Act must be added to any benchmark rate arrived at by the Commission. *See, e.g.*, Comments of Intermedia Partners at 18; Comments of Cablevision Industries at 21-22; Comments of Continental at 33; Comments of Time Warner at 107-09. As NAB explained in its initial comments (pp. 6-7), however, Congress found that the rates now charged by cable systems include the value which subscribers obtain from receipt of broadcast stations' signals, but which cable systems do not now pay to use. The cable comments do not attempt to address this point and suggest only that, as an additional cost, the benchmark price would have to be adjusted to accommodate the new burden on the cable system. Were the Commission to accept proposals to mandate a rate-based benchmark *and* permit cable operators to add retransmission consent costs to that price,

^{11/} 169 U.S. at 544-45.

cable systems would obtain a double windfall at the expense of consumers. Further, that unjustified recovery would be substantial.^{12/}

If the Commission establishes a benchmark based on present or historical rates, it could avoid leaving cable operators with unjustified revenues by ruling that retransmission costs could not be added to a rate-based benchmark because their value is already included in that rate. While superficially attractive due to its simplicity, that approach could also result in undesirable distortions. To the extent that popular local stations elected to accept must carry rights and not seek compensation, that would give cable operators a windfall since the current situation where subscribers pay for such signals but cable systems do not compensate stations would continue. It would also create incentives for cable operators to refuse to negotiate for the true

^{12/} There have been a number of efforts to quantify the value which carriage of over-the-air television signals brings to cable systems, many by entities affiliated with or commissioned by the cable industry itself. These estimates would provide a useful base were the Commission to undertake the task of separating out retransmission revenues from a rate-based benchmark. In 1988, shortly after cable rates were deregulated, Merrill Lynch estimated that broadcasters were subsidizing cable operators by approximately \$3-4 billion annually through cable systems' free use of broadcast signals. See Merrill Lynch Capital Markets, *The Year Ahead: Broadcasting* (Dec. 13, 1988). In January 1989, *CableVision* reported on several cable industry estimates of the value of broadcast signals to cable operators. The lowest reported estimate was 14-21 percent of total subscriber fees. *CableVision*, Jan. 30, 1989, at 35. A Bortz Browne Coddington study found that carriage of local broadcast signals contributed 33-56 percent of cable systems' monthly net operating income, including income from pay services and other sources. A later Paul Kagan analysis also determined that broadcast signals contribute over half of cable system net revenues. Paul Kagan Associates, Inc., *Marketing New Media*, Jan. 15, 1990. Even if the Commission might conclude that these estimates do not accurately delineate the market value of broadcast signal carriage, they decisively demonstrate that some substantial portion of existing cable rates must be attributed to the value provided by broadcast signals.

value of broadcast signals since, absent any payments to broadcasters, they could retain the amounts subscribers paid for those signals. This would be akin to the incentives such a rate-based benchmark would create for cable operators to change their cable programming lineup towards less expensive services. Alternatively, the Commission could attempt to create a formula to decide what proportion of any historical rate was based on the value of retransmitted broadcast signals and reduce the benchmark accordingly.

A better and less costly way to address retransmission consent (as well as any other new costs incurred by cable systems) would be a cost-based benchmark system such as the one proposed by NAB. Under that system, the costs of retransmission consent would be treated like any other direct costs for program services carried on a cable system's basic tier, as suggested by the directive of § 623(b)(2)(C)(ii) to take into account the costs of "obtaining, transmitting, and otherwise providing signals carried on the basic service tier."

The Cable Act Does Not Mandate a Limited Basic Service Tier

NCTA (Comments at 4-6) and other cable operators contend that Congress intended the creation of only a very narrow basic tier, limited to broadcast and PEG channels, and that only limited rate regulation was intended to apply to other tiers. While the Act *permits* cable operators to provide such a limited basic service tier, there is nothing in that Act that *requires* them to retier in this fashion or which mandates the Commission to establish rules designed to bring about that result. The reason why the mandatory components of the basic service tier are limited to broad-

cast signals and PEG channels is that these services are almost universally provided by cable systems. Congress recognized that cable systems included differing services on their basic tiers and that "to control what should be offered on the basic tier — is not practical and it at least would raise First Amendment concerns."^{13/} That is a far cry from a Congressional direction to limit basic service to only the required signals.

Indeed, were that Congress' intent, it would not have included in § 623(h) explicit language barring evasions of rate regulations through retiering, and noted that "cable operators have shifted cable programs out of the basic service tier into other packages and that this practice can cause subscribers' rates for cable service to increase."^{14/} If Congress had intended the Commission to mandate the creation of a tightly regulated and limited basic service tier with cable program services moved to lightly regulated upper tiers, it would have *required* retiering, rather than providing that retiering could be viewed as an evasion of the law.^{15/}

The Commission, therefore, should avoid rate regulation plans which would create incentives for cable systems to move popular programming to higher tiers, particularly if the price charged for the higher tier would be equivalent to or higher

^{13/} *Senate Report* at 19.

^{14/} H. REP. NO. 862, 102d Cong., 2d Sess. 65 (1992)[hereinafter *Conference Report*].

^{15/} In light of § 623(h), it is surprising that in a recent newsletter, CATA urged any of its members who have not retiered to create a limited "broadcast basic" tier to do so before the Commission adopts rate regulation rules in April. CATA warned its members that the Commission's rules might make it difficult to move services to less regulated tiers. "Tiering: First Order of Business," *CATAcable*, January/February, 1993, at 6.

than the same system charges for cable service now. Not only would that result be inconsistent with Congress' intent, it would result in a greater burden on the Commission and its staff to deal with a larger number of complaints about pricing of such cable programming tiers. Because NAB's rate proposal allows for prices to vary with the size of the basic tier and the programming provided as part of basic service, cable operators would not be pressured into creating extremely narrow service tiers.^{16/}

Alternatives for Regulating Basic Service Tier Rates

The Commission offered a number of different approaches to basic service tier regulation in the *Notice*. NAB proposed a variation on one which provided for a benchmarked rate for the capital cost of providing basic service, and allowed prices to reflect the actual non-capital costs attributable to basic service. Many of the cable comments on basic tier regulation are unhelpful because they either fail to support any proposal or suggest alternatives that would be unduly complex to implement. TCI, for example, appears to raise questions about every alternative proposed by the Commission, but suggests no better approach of its own. Instead, it "withholds further comment until both the [Commission's requested cable pricing] data and the FCC's usage thereof is available to the Commission and the industry for analysis and review." Comments of TCI at 17; *see* Comments of Time Warner at 23. The Act,

^{16/} NAB also proposed to permit cable systems to retain all of the revenues they receive from advertising sold on basic tier cable program services, although the legislative history indicates that the Commission could require an offset for such revenues in the basic tier rate. *See Conference Report* at 63. This would establish some incentive for cable operators to keep popular services on the basic tier since they could therefore maximize the services' potential audiences and enhance their attractiveness to advertisers.

however, directs the Commission to adopt rate regulation rules by April 5, 1993. Although TCI may wish to wait until some date in the future to decide what would be the most appropriate regulatory scheme, the Commission does not have that luxury and must make at least an initial choice now.

Certain things, however, are clear. No party appears to support the adoption of traditional telephone-type cost of service regulation for the cable industry. Countless pages are spent in the comments rehearsing the well-established reasons why such regulations are expensive, difficult to administer, and result in undesirable incentives. Since the Commission did not propose to adopt a cost of service rate plan and the legislative history also counsels against such a choice, the reasons for expending this massive effort to "kill a dead horse" are baffling.

The remaining approach is some type of benchmark or price cap. Benchmarks, of course, must be based on something and not just plucked from the air as the Commission's (or franchise authorities') *a priori* notion of what reasonable prices should be. Again, there seem to be only two basic ways to establish a benchmark — rates or costs. A benchmark or cap could be developed on the basis of the rates charged by selected cable systems at certain times which collectively could be deemed to represent a reasonable rate. Alternatively, a benchmark could be established using data about the costs of constructing and operating a cable system. A benchmark approach based on costs does *not* replicate the evils of traditional cost-of service regulation.^{17/}

^{17/} NAB-SPR Study at 4-5.

Rate-Based Benchmarks Would be Difficult to Implement

No system of establishing a benchmark or cap is likely to be perfect, and the Commission's task is to select the approach which is likely best to achieve the goals of controlling rates without imposing significant enforcement costs or creating incentives to "game" the system. A rate-based benchmark appears to be the preferred method of most cable operators. *See, e.g.,* Comments of Comments of NCTA at 26-27; Comments of TCI at 16-17. There are, however, a number of disadvantages to a rate-based cap. First, it will be difficult to select a sample which will yield useful data about reasonable rates. The number of cable systems which face meaningful competition is limited, and extrapolating their rates to other systems which include different amounts and types of programming on the basic tier or which have different engineering and construction costs would be problematic.^{18/}

Using historical rates to establish a benchmark presents problems because it is difficult to determine whether any particular historical rate is truly that which a cable system would have provided under competitive conditions.^{19/} Further, the Commis-

^{18/} See Besen, Brenner & Woodbury, *An Analysis of Cable Television Rate Regulation* 18-23 (Attachment to Comments of TCI)[hereinafter *TCI-Besen Study*].

^{19/} We note that cable operators complain that pre-1986 rates were often established due to political factors and did not represent a rate necessary to economically provide cable service. Whether or not this was so either generally or in any particular case is not the issue; the fact that the question is raised indicates that the Commission will not be able to accept such historical rates as an adequate pointer to what competitive cable rates would be without extensive further exploration. It is interesting, however, that, despite these allegedly confiscatory rates, it does not appear that cable operators before passage of the
(continued...)

sion would have to establish a formula to modify 1984 or 1986 rates to account for increases in costs and changes in cable systems and their program offerings.

In doing so, the Commission could not merely use an inflationary measure such as a simple price or service index. Because cable penetration dramatically increased in the last decade, adding to the number of subscribers served by the same cable plant, the actual cost per-subscriber or per-channel of providing cable service on many systems may have declined, and certainly cannot be assumed to have increased at the same level as any general inflationary measure. While cable operators such as Continental (Comments at 25-26) argue that cable television is characterized by increasing costs, these arguments are made on a cable system basis without examining the direction of per-subscriber costs, nor considering whether certain costs were incurred to allow cable systems to provide non-cable services in the future. *See* Comments of GTE at 8.

Regardless of what method is used to set an initial rate benchmark, the same issue arises as to how the Commission would permit adjustments in the future. The suggestion in the *Time Warner-Kelley Study* (p. 31) that a rate-based benchmark be adjusted in accordance with one or another general inflation factor is inappropriate in the absence of any evidence that these general measures of inflation are a reasonable proxy for cable system cost increases. *See also* Comments of Intermedia Partners at

^{19/}(...continued)

Cable Act in 1984 sought to have local authorities' rate-setting activities declared unconstitutional, or that many systems were, in fact, unable to survive under pre-deregulation rate regimes.

21. Other comments suggested various complex formulas based on costs in systems owned by other MSOs^{20/} or on adjusted median rates for systems deemed to operate under competitive conditions.^{21/}

While use of average present rates might eliminate some of these required adjustments, the Commission would have no basis on which to conclude that those rates reflect what prices would be under competitive conditions since all but a few cable systems presently operate as monopolies. Adopting present rates as a benchmark and requiring adjustments only for cable systems whose pre-regulation rates are at the top edge of the price scale would not be responsive to Congress' determination that cable systems across the industry have been able to extract monopoly rents since 1986.

Even more significantly, adopting a rate-based benchmark would require the Commission to make a series of difficult unbundling decisions. Most cable rates now include at least some charges for equipment. Since local authorities and the Commission will now regulate equipment charges separately, a rate-based benchmark would have to include a method to remove the portion of the benchmark price attributable to equipment. See Comments of Time Warner at 23; *TCI-Besen Study* at 18-20. Also, as we discuss *supra* pp. 8-10, if the Commission adopts a rate-based benchmark, it will either have to bar cable operators from making any adjustments to that rate due

^{20/} *TCI-Besen Study* at 35.

^{21/} Owen, Baumann & Furchtgott-Roth, *Cable Rate Regulation: A Multi-Stage Benchmark Approach* 24 (Attachment to the Comments of NCTA).

to payments for retransmission consent, or else reduce the benchmark by an amount which represents the uncompensated value previously derived by cable systems from carriage of broadcast signals. Any rate-based benchmark, therefore, will engender substantial difficulties in application.

Cost-Based Benchmarks Would Work Better With Lower Administrative Burdens

A cost-based benchmark like the approach proposed by NAB, by contrast, entails far fewer difficulties. It does require the Commission to establish a means to identify which costs a cable system would have to incur to provide service, and separate those recoverable costs from others which reflect capitalized expectations of future monopoly profits, but this task would be far less onerous than a complex evaluation of the costs incurred by individual cable systems. NAB suggests that using replacement costs to set the benchmark for capital costs would effectively separate out those prudent costs which cable systems must be allowed to recover from investments which reflect monopoly rents.^{22/}

Resting a benchmark or cap on costs also provides a simple way to exclude preexisting retransmission revenues from rate calculations without having to determine what those revenues were, either generally or for any particular cable system. The

^{22/} A different approach with the same objective is GTE's proposal to reduce benchmark prices by an amount attributable to cable operators' costs associated with goodwill. See Comments of GTE at 9. Calculating which portion of each system purchase should be attributed to goodwill, and then relating the product of that analysis to the prices charged by a cable system and the portion which should be allocated to the basic service tier, would be burdensome. The NAB proposal eliminates the need for such laborious efforts to apportion historical costs and would be easier and cheaper to implement.

cost of retransmission consent could then be treated the same as any other direct costs of services carried on the basic tier.

Using replacement costs would also simplify the data collection necessary to establish a rate. Were actual costs to be used, each cable system's costs would have to be individually established and evaluated with all of the attendant difficulties which telephone-type cost of service regulation requires. A replacement cost matrix can be established using readily established data concerning the factors which determine cable system construction costs and present cost data for such construction. This information can be updated with a minimum amount of effort by the Commission and updated cost estimates can be easily factored into local authorities' rate calculations.

A replacement cost matrix to determine recoverable capital costs also makes cable systems' rates responsive to particular local conditions. A cable system in a high-cost construction area (such as where underground cable is required) will be able to charge higher prices than one where construction is inexpensive. A rate-based system, on the other hand, will tend to penalize operators in high-cost areas (and conversely provide a windfall for operators in low-cost environments) because the inherently average nature of the benchmark cannot take such local variations into account. *See TCI-Besen Study* at 16. Thus, the NAB proposal addresses the concern raised by BellSouth (Comments at 5-6) about many benchmarks which fail to account for cost variations between systems.

Moreover, the replacement cost benchmark proposed by NAB would not create incentives for inefficient construction or operation of cable systems like traditional